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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Ex Parte

February 26, 1999

The Honorable William E. Kennard
Chairman
Federal Communications Commission
1919 M Street, NW, Room 814, SC 101
Washington, D.C. 20554

Re: Implementation of the Local Competition Provisions in the Telecommunications Act of 1996; CC Docket No. 96-98

Dear Chairman Kennard:

We are now at a crucial stage in the implementation of the Telecommunications Act of 1996, with new entrants facing great uncertainty as they decide which markets to enter and what investments to make. Many of these business decisions are being delayed by the uncertainty surrounding key parameters for which regulatory decisions are needed, such as: the availability and pricing of unbundled network elements; and the size, scope, and form of universal service funding. Perhaps the linchpin for all these regulatory decisions — and all the business decisions that will flow from them — is how the rates for unbundled ILEC loops will be set.

In this letter, I shall lay out for you why it is essential that the Commission maintain its current rule requiring that ILEC loop rates be deaveraged into at least three cost-based zones.

Loop rate deaveraging is a key part of cost-based pricing

Section 252(d)(1) of the Telecommunications Act requires that the rates for unbundled ILEC network elements be cost based (determined without reference to a rate-of-return or other rate-based proceeding). This reflects Congress' recognition that new entrants would not be able to duplicate the existing public switched network in a reasonable period of time, that indeed it would not be in the public interest for them to do so, but that the American public would benefit if new entrants were able to share in the economies of scale and scope associated with the public switched network by having access to unbundled ILEC network elements at cost-based rates. In implementing this portion of the Act, the Commission reviewed cost information and substantial

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analysis performed by many parties (ILECs, IXCs, State regulatory commissions) and based on that comprehensive record found that loop costs are very sensitive to population, loop density, and other factors that vary geographically. In the Local Competition Order, the Commission found:

> that deaveraged rates more closely reflect the actual costs of providing interconnection and unbundled elements. Thus, we conclude that rates for interconnection and unbundled elements must be geographically deaveraged. (First Report and Order, ¶ 764)

Further analysis performed by the Commission, the Department of Justice, and other parties subsequent to the Report and Order corroborate this conclusion. The Commission's very extensive efforts in reviewing cost models developed by other parties, as well as developing its own forward-looking economic cost model for calculating the size of the Universal Service subsidy, all lead to the incontrovertible conclusion that loop costs vary substantially by geography.

These studies demonstrate that the variance of loop costs within LEC study areas typically range by a factor of twenty to one, e.g. from a cost of $5 in dense urban areas to $100 in rural areas, with an average below $15. It defies common sense to consider the statewide average loop rate as a "cost-based" charge in either the urban or the rural area. By no stretch of the imagination can a rate 200% above cost (a $15 rate, where cost is $5) or 85% below cost (a $15 rate, where cost is $100) meet the statutory standard, nor is it consistent with the Commission's carefully crafted logic in the First Report and Order.

The Telecommunications Act instituted a paradigm change in telecom public policy, focusing on how best to utilize competitive market forces, rather than monopoly regulatory constructs, to benefit the American people. Markets, which are shaped by and respond to underlying costs and demand, do not conform to regulatory study areas, which were created under the old monopoly rate-of-return paradigm, and any attempt to make market signals (prices) conform to regulatory study areas undermines the Act and is destined for failure.

Why it is so important to deaverage loop rates

It is important to deaverage loop rates for the same reasons that Congress and the Commission have required cost-based pricing in general. To establish efficient markets, the players in the marketplace must receive pricing signals that reflect the underlying costs to society of providing a good or service. For competitors to make efficient decisions on whether, when, and where to buy a network element or build their own facilities, they must have price signals that reflect actual economic costs. Loop plant is the most costly portion of the public switched network. If decisions to buy or build are skewed by rates that do not reflect cost, they can result

in very substantial distortions in investment decisions that result in inefficient overbuilding or in harmful delays in competitive entry. As discussed in greater detail below, these distortions can keep efficient entry from occurring at all.

These general market verities are all the more important in an industry characterized by an incumbent monopolist and a number of potential entrants. The incumbent will know its cost structure and be able to make business decisions accordingly. Potential entrants will always face greater market uncertainty than incumbents because they are starting from a zero customer base and must create all types of new business relationships. If, on top of this, they face uncertainty about the prices they must pay for essential inputs that represent a large proportion of their total costs — or uncertainty about if and when they will have access to those inputs at deaveraged rates that place them on the same cost footing with their dominant competitor — their market uncertainty will be compounded. Uncertainty is costly, for it makes each and every market decision — on where and when to commit scarce resources (not just for plant, but also for marketing and for the development of billing, ordering, and provisioning systems) — more risky. The recent Supreme Court decision helped remove some of the uncertainty faced by the new entrants concerning the regulatory rules of the road. The Commission should not now reintroduce this uncertainty by sending out a signal that geographically averaged unbundled loop rates may be acceptable after all.

Deaveraged loop rates will foster the competitive provision of local service for residential and small business customers

CLECs can only enter those markets where expected revenues equal or exceed their expected costs. I will illustrate the effect of deaveraging of loop rates by looking at a simplified numerical analysis of the entry decision faced by CLECs. For residential and small business ("mass market") customers, local revenues per subscriber tend to be somewhat higher on average in geographic areas that have a greater density of loops than in those with a lower density, increasing from about $24 per month in rural areas to just over $30 in urban areas in most states. The total costs to a CLEC of providing local service, exclusive of the loop cost, are about $20 per subscriber. (These non-loop costs include billing, marketing, and systems costs, plus switching and transport costs — whether provided by the CLEC itself or acquired as UNEs from the ILECs. They will vary from state-to-state, especially where the CLEC relies on UNEs.) This leaves about $10 to cover the cost of the loop in the urban areas, and even less in rural areas.

In most states, where loop rates are averaged, prices are set well above $10 a month, and under these conditions entry into the mass market will not be profitable and will not be pursued by the CLECs. If, on the other hand, loop rates are deaveraged to reflect underlying economic costs, then the loop rate will fall to the $5 to $10 range in the more urban density zones, and in these zones, it will be viable for a new entrant to serve the mass market. (Of course, whether the new entrant actually enters a market will depend on the number of other factors, such as its

ability to gain access to UNEs, singly and in combination, the level of nonrecurring charges, and the adequacy of OSS systems. Also, since revenues and non-loop costs per line are different in each state, the breakeven loop rate may be either higher or lower than $10 a month. Nevertheless, the qualitative conclusion about the effect of loop rate averaging is correct, and a critical element determining the future of competition in local markets.)

It is important to understand that the geographic zones with greatest loop density do not just represent big business districts like Wall Street. For example, one third of all loops in the Bell Atlantic region in New York represent primary residential lines in census blocks with greater than 5,000 line per square mile (the top two density zones in the HAI model). This amounts to about 3.7 million residential customers. The failure to set a deaveraged loop rate for this part of the market will reduce competition for residential and low-end business customers.

The Department of Justice clearly understood this market reality when, in its Evaluation of BellSouth's second application to provide interLATA service in Louisiana, it found (at 20):

> We continue to believe that the ability to obtain unbundled loops at appropriately deaveraged prices may be critical to enabling facilities-based CLECs to expand their service offerings beyond centrally located large business customers (for whom these carriers can economically provide their own loops) to smaller and more dispersed small business or residential customers in urban areas served by central offices near the CLECs' facilities.

Viable mass market entry in urban areas, that will be possible only with cost-based deaveraged loop rates, is only the first step in the competitive provision of service to all residential and small business customers, but without that first step further competition will not develop. Once entry occurs in dense urban areas, entrants can begin to capture scale economies in marketing, billing, and systems that will allow them to compete in other markets with higher costs. With the availability of universal service funding plus some of the economies gained from successful urban penetration, entrants will be able to expand into rural markets. But those rural markets will not be well served in the long run if loop rates remain averaged. With averaged rates, some entrants might choose to enter rural markets, taking advantage of their access to loops at rates that are below cost. Those same below-cost loop rates, however, will discourage potential entrants with new, low cost loop technologies, such as wireless providers, from entering and providing facilities-based competition to ILECs in rural areas that will reduce the underlying cost structure for providing service. Rural communities will remain dependent on subsidies when new low-cost technologies could better serve them.

Loop rate averaging is inconsistent with the good public policy principles embedded both in the Act and in the Commission's earlier orders

Loop rate averaging is an implicit form of cross subsidy and, as such, is in direct conflict with the requirement of the Act to remove implicit subsidies from universal service funding. Some parties claim that loop rate averaging is needed to get new entrants to enter rural as well as urban markets, arguing that incumbents serve all geographic areas under the constraint of averaged local rates and that loop rate averaging will leave entrants in the same market position. This is contrary to the law of the market, to good public policy, and to the law of the land.

First, it is impossible to compel new entrants to copy the implicit subsidy structure built into ILEC rates, because the new entrants do not have the same cost structure and customer base as the incumbents. ILECs can maintain a rate structure with embedded implicit subsidies because they do not yet face sufficient competition that would drive rates toward cost. ILECs are able to maintain these distortions because they have virtually the entire customer base in the market; a small erosion of revenues through the loss of a few customers does not significantly effect their overall profit positions. In fact, the combination of loosened (alternative) regulation, technology-driven declining costs, and lack of competition have left ILEC profit rates at an all-time high today.

New entrants, on the other hand, face an entirely different profit picture. Their costs per-customer are much higher than the ILECs', because they cannot achieve the same economies of scale. Further, they face significant marketing costs to attract customers away from the ILECs. They face an even higher cost disadvantage in less dense areas, where their inability to achieve scale economies would be especially acute. Hence, the CLECs cannot and will not enter a broad cross-section of geographic markets simply because they face one cost variable -- UNE loop rates -- that is geographically averaged.

Second, failure to deaverage loop rates is the same as purposely slowing down (or stopping) entry into high density zones. Ostensibly, this can be justified by the need to "protect universal service." That is, some parties argue that deaveraged loop rates will foster competitive entry in low cost areas that will erode ILEC prices, which would require an increase in local rates in rural areas, thereby threatening universal service. This line of reasoning yields a bad public policy prescription — effectively, a tax on new entrants in the form of above-cost price for an essential input, which is intended to retard their entry into the market. It relies on several questionable assumptions. First, it assumes that the competitive entry made possible by deaveraged loop rates will result in an immediate hemorrhaging of ILEC rates and revenues. There certainly is no evidence to date that this will happen; it certainly has not happened in markets where entry is easier (large business market). Further, impediments remain in the form of inadequate OSS systems, inflated nonrecurring charges, and restricted access to individual and combined UNEs. Second, it assumes that all the revenues above cost generated by urban rates

are needed to fund universal service. In fact, the results of the forward looking cost models show that the amount needed to support universal service is far smaller than the ILEC revenues generated by above-cost rates, hence it is clear that these revenues are not all needed for universal service. Third, and most insidious, it is based on the tacit assumption that ILECs are entitled to a guaranteed level of revenues, and if competition were to erode some of these revenues the ILECs have the right to increase revenues from captive customers, thereby endangering universal service. This argument must be rejected out of hand.

Some parties have suggested that loop rate deaveraging should simply be delayed until the Commission implements the new explicit interstate high-cost fund for non-rural LECs on July 1. But this begs the question. When the Commission implements the fund, it will create the mechanism needed to provide the interstate portion of the total universal service subsidy required. The States will still need to provide their portion, and are likely to ask for a further delay in loop rate deaveraging to protect implicit subsidies, until they have developed and funded an explicit subsidy fund. It is too easy to give into the temptation to put off procompetitive policies until conditions are "just right."

Thank you for your attention to this matter. I would be happy to discuss the issues raised in this letter at any time.

Sincerely,

Michael D. Pelcovits

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cc: Commissioner Susan Ness
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